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# 1989 UPDATE ON THE LIBERALIZATION OF JAPANESE FINANCIAL MARKETS

Summary

Having solved most of the "easy" financial liberalization issues, the Ministry of Finance is edging toward resolution of such sensitive issues as insider trading, the barrier between investment and commercial banking, deregulation of deposit interest rates and foreign access to Japan's financial markets. Even as MOF moves ahead, however, new issues are cropping up that could lead to far-reaching changes, not only in Japan's financial markets but in business behavior as well.

## Moving Ahead, But Still Behind

Financial liberalization in Japan is entering a new period of intense debate and examination. A 1988 report commissioned by the Economic Planning Agency warned that Tokyo financial markets are falling behind their London and New York competitors in the race for complete liberalization and integration with global markets. The slow rate of liberalization could prevent Tokyo from fulfilling its potential as a global money center, the report says. The Finance Ministry realizes that it must move forward on liberalization, but progress is becoming more difficult as the issues gain complexity.

To compile the report for EPA the Japan Research Institute surveyed 107 foreign and 94 Japanese firms. The non-profit think tank examined four areas of services trade, with particular attention paid to the financial field. "The institutional incompleteness of short-term money markets interferes with internationalization of the Tokyo money market," the survey concludes. It points out that Tokyo's markets lag in many respects. Tokyo ranks third in terms of daily foreign exchange trading volume behind first-place London and New York;

the outstanding volume of Tokyo short-term money markets is a fraction of its American and British competitors; and the controls put on Tokyo's markets are stifling compared to regulations in New York or London. The report underscores the last point by referring specifically to a drop in lending in Japan by foreign banks, which are dependent on short-term markets for fund-raising. "Strict administrative guidance by the Finance Ministry, in substance, blocks foreign banks from mergers and acquisitions of Japanese banks in an attempt to expand their retailing activities, which they expect to contribute to lower fund-raising costs," the EPA report explains.

"We must admit that Tokyo lags far behind London and New York in terms of market openness," the report goes on to charge. Although the data are old, the report claims that as of October 1984, London subsidiaries of Japanese banks held 21.9 percent of the financial assets in that market, while the share of all foreign banks in Tokyo came to just 1.3 percent. Moreover, while Japanese securities firms bought 40 to 60 percent of all newly issued U.S. Treasury bonds in 1986 and 1987, the foreign share of Japan's primary government bond market is small (but growing). Since JEI's last report on this subject (JEI Report No. 6A, February 12, 1988), MOF has tried to address a wide range of issues.

Banking On Reform

The once staid Japanese banking market is being shaken from top to bottom. The increasing intensity of domestic and international competition is forcing both the government and financial institutions to reexamine traditional practices and structures. Debate over fundamental issues -- including the barrier between investment and commercial banking, divisions within the banking industry and deregulation of interest rates -- has split both the Ministry of Finance and the private sector into several factions. In its incremental approach to reform MOF is trying to carefully balance the gains and the losses for each faction, no simple task. The ministry and the industry, however, realize that Japan must move ahead if it is to remain an internationally competitive financial center.

Article 65 - MOF's Financial System Research Council has established a special expert subcommittee composed of academics and businessmen to deal with the sensitive and difficult issue of how to allow commercial banks and securities firms to compete in each others' markets. Article 65 of the Securities and Exchange Law, modeled after the United States' Glass-Steagall Act of 1933, establishes a wall between domestic commercial banking and brokerage activities. After tasting this forbidden fruit by being allowed to compete freely in Europe, Japanese banks and brokers have acted aggressively to create or expand holes or gray areas in the Article 65 wall at home and abroad.

In the United States, for example, Japanese banks have or are opening securities operations to deal in a limited range of instruments, permitted as long as they don't simultaneously engage in banking here. Sanwa Bank, Ltd. won permission from the Federal Reserve Board to underwrite and deal in commercial paper, municipal revenue bonds and asset-backed securities. Dai-Ichi Kangyo

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Bank, Ltd. expanded its presence in underwriting, dealing and brokering of U.S. Treasury bonds through a wholly owned subsidiary. Taking the most provocative step, however, was the Industrial Bank of Japan, Ltd. IBJ's European subsidiary, IBJ International Ltd., obtained a seat on the London stock exchange and announced plans to trade not only foreign equities but 10 Japanese stocks as well. The move revealed a split within MOF bureaus; its commercial banking unit approved the step, but the securities branch was not informed of the move in advance. After some internal talks and IBJ's pledge that its London subsidiary would not sell Japanese stocks to Japanese residents, MOF decided against any action. Nevertheless, the situation indicated the intense interest in breaching the banking/securities wall.

The Ministry of Finance, hoping to clarify the banking/securities regulatory environment for domestic and foreign firms, asked its advisory council to examine five options:

- A "universal" banking system like the one employed in most European markets. This approach allows a financial institution to compete directly in any and all areas.

- A holding company structure that would allow firms to create umbrella organizations whose subsidiaries would conduct banking and securities operations independent of each other. Trust and banking operations would be insulated from each other as separate corporate entities. This arrangement would protect the assets of one subsidiary from liability claims against another and would make it less likely that proprietary client information would be misused (as for insider trading, for example). This is similar to the current U.S. system.

- A wholly owned subsidiary system under which banks and securities firms would compete in the other's market through wholly owned operations. Unlike the previous option, the parent corporation could become entangled in the financial difficulties of its subsidiary. This is modeled after the Canadian deregulation of 1987.

- An investment bank subsidiary system that would allow banks and brokers to establish a wholly owned investment bank subsidiary offering commercial and investment services to large institutional clients only.

- Modest modifications to the existing system, such as very specific and limited channels for banks and securities companies to compete in each others' markets.

The expert panel ruled out the first and last options. Universal banking could lead to undesirable consequences, according to panel head Ryuichiro Tachi of Tokyo University. Large commercial banks with their extensive network of offices could dominate the brokerage business, he argued, while the government could face added liability if it guarantees savings deposits handled by securities companies. (Government guarantees currently apply only to deposits at banks.) At the other end of the spectrum, specifically modifying certain aspects of the current system is considered unrealistic given the recent activities of financial firms. As indicated earlier, Japanese banks and brokers are active in seeking or exploiting gray areas in the existing law. Professor Tachi is worried that if the erosion of the law by private firms is allowed to continue unchecked, Japan's financial markets could not only become disorderly

but less transparent to foreign firms. If Tokyo is to become a global money center, he contends, the rules must be transparent to foreign and domestic firms alike and operate in line with global practices.

After further study a subcommittee of the council narrowed the options to just two. Rejecting the extremes of universal banking and the ad hoc approach, the subcommittee also dropped the holding company scheme, which would have required extensive changes in Japanese antimonopoly law, affecting all Japanese corporations rather than just the financial sector. The surviving proposals are: multiple, wholly owned subsidiaries and wholesale investment bank subsidiaries.

The first of the remaining proposals would spur competition in the full range of financial services. Those institutions with a network of national and international offices to service the retail as well as the wholesale market, such as the major commercial banks, would have a built-in advantage. This alternative, however, could lead to increased concentration of financial power, with implications for domestic and international competition. The second option would reduce the likelihood of this happening but also would provide less of a competitive jolt since not all institutions are likely to take the plunge into setting up investment bank subsidiaries. In particular, small firms, whether domestic or foreign, would be left out of the picture.

Both proposals create the potential for major conflicts of interest between the commercial and the investment banking arms of a single firm since they each could serve the same client. The financial chaos of the 1930s stemmed in part from banks loaning to clients they also served as underwriters. The Glass-Steagall Act resulted then. And now, as Japan's equivalent measure, Article 65, is moving toward change, this issue must be dealt with before the Japanese government can draw up implementing legislation. Securities firms are likely to fight the proposed changes any way they can. Compared with banks brokerage firms have fewer offices; they feel either proposal would put them at a competitive disadvantage.

The consensus for essentially eliminating Article 65, however, seems firmly entrenched. Diverse preparations are under way. Such groups as trust banks, long-term credit banks, small banks and even insurance companies, all are angling to preserve their interests. Some Japanese commercial banks already are dabbling in securities activities overseas, while Japanese brokerage houses have been involved in commercial banking in Europe for some time.

Distinctions remain, however. Taking their cue from the dismal stock trading results that some overanxious banks experienced in 1988 when Britain dropped its remaining barriers between the fields (the so-called Big Bang), Japanese banks and securities firms are likely to move cautiously whichever option is selected.

After receiving the subcommittee's report May 16 the full council forwarded its recommendations to the Ministry of Finance. The council by no means has the last word, however. Other advisory bodies, particularly ones dealing with securities and insurance, are drafting their own reform suggestions. The toughest battles may be fought within MOF itself between the banking and the securities bureaus. Whichever direction Tokyo finally moves, the changes probably will make Japan's financial institutions more flexible competitors instead of leading to a shakeout in the industry.

Trust banking - A Finance Ministry proposal would allow both banks and securities companies to establish investment bank subsidiaries able to deal specifically in the lucrative pension and trust markets. Although the subsidiaries would be restricted to handling the large accounts of corporations and institutional investors, they would be free to extend loans, settle portfolio accounts, trade foreign exchange, underwrite bonds and broker securities transactions. Major commercial banks have rejected the idea as "unrealistic" and called instead for a universal banking system. Securities companies also view the MOF proposal with some trepidation but see the universal banking concept as even riskier. MOF will continue to work on the idea, but it is unclear if it can satisfy all parties.

Bank categories - An advisory council recommended the elimination of the distinctions between sogo (mutual savings) and commercial banks as part of an overhaul of the domestic banking system (see JEI Report No. 46B, December 11, 1987). The first 55 sogo banks with capitalization of over Y1 billion ($7.1 million at Y140=$1.00) converted on February 1, 1989; another 10 followed on April 1. The remaining three sogo banks are in ill health, and it is unclear when or if they will revise their status. The change has spurred competition at the low-end of the market and increased merger and acquisition activities. The conversion also has increased the chances that an American bank will buy a Japanese institution. Citicorp is among those said to be holding active discussions with at least two former sogo banks.

Capital ratios - To put all banks involved in international transactions on more sound and equal footing, the Bank for International Settlements issued minimum requirements for capital-to-asset ratios in December 1987 (see JEI Report No. 47B, December 18, 1987). Under MOF's new rules to ensure compliance with the BIS guidelines all Japanese banks with international operations (35 institutions at present) must raise their overall capital-to-asset ratios to 7.25 percent by October 1, 1992 and then to the full BIS-mandated 8 percent by March 31, 1993. The impact of the BIS guidelines on Japanese banks is potentially very broad (see JEI Report No. 25B, July 1, 1988), and the first wave of effects already is apparent.

Japanese banks raised an estimated Y2 trillion ($14.3 billion) in new equity in FY 1988 through issues of convertible bonds or straight shares in Japan and Europe. This intense activity involves twice the amount of CBs and new shares floated in FY 1987 and has caused chaos in domestic and overseas CB markets. However, the need for capital may be so great that no option may be left idle. Under consideration, for example, is a plan allowing banks to switch to offering preferred stock, a recommendation by a MOF advisory panel. The American Bankers' Association predicts that Japan's top 31 banks will have to raise more than $400 billion in equity by 1992 if they restrain all asset growth. This amount rises to $500 billion if asset growth is allowed to go as high as 10 percent.

The Finance Ministry is doing its part to help banks meet the BIS standards by examining rule changes that would allow banks greater flexibility and increase their earnings potential. Restrictions on overseas holdings by Japanese banks were liberalized at the start of 1989, a beneficial move since foreign operations generally are more profitable than domestic activities. MOF also is considering letting the foreign subsidiaries of Japanese banks underwrite overseas issues by Japanese firms of foreign currency-denominated bonds.

Another plan calls for raising the maximum amount of reserves backing poorly performing Third World loans to 15 percent from 10 percent of the outstanding amount. While the main intent of this change is to encourage Japanese banks to take a more active role in financing Third World development, it also will have the effect of improving capital-to-asset ratios.

Japanese banks made solid progress in 1989 toward meeting the new capital guidelines, according to data from the American Bankers' Association. The data list Yasuda Trust & Banking Co., Ltd. as leading Japanese institutions with equity growth of 58.5 percent, followed by Mitsubishi Trust & Banking Co., Ltd. with 58.2 percent. Most other Japanese institutions posted growth of between 45 percent and 17 percent. This spectacular performance still leaves the Japanese banks short of their goal, however. The strongest Japanese bank, according to ABA, is Shizuoka Bank, Ltd. with an equity/asset ratio of 4.29 percent. Other Japanese institutions have ratios ranging from 3.3 percent to 0.57 percent (see Table 1). American competitors, in contrast, generally are better off by this measure, with most ratios in the 3 percent to 7 percent range.

Table 1: Equity-to-Asset Ratios of U.S. and Japanese Banks

(as of December 31, 1988)

| Company | Equity/Asset Ratio |
|---|---|
| J.P. Morgan & Co. | 6.99 |
| Bankers Trust New York Corp. | 6.63 |
| Chemical Banking Corp. | 5.95 |
| Chase Manhattan Corp. | 5.18 |
| Manufacturers Hanover Trust Corp. | 4.95 |
| Citicorp | 4.84 |
| BankAmerica Corp. | 4.44 |
| American Express Co. | 3.54 |
| | |
| Shizuoka Bank, Ltd. | 4.29 |
| Industrial Bank of Japan, Ltd. | 3.33 |
| Fuji Bank, Ltd. | 2.95 |
| Long-Term Credit Bank of Japan, Ltd. | 2.92 |
| Dai-Ichi Kangyo Bank, Ltd. | 2.83 |
| Mitsubishi Bank, Ltd. | 2.82 |
| Tokai Bank, Ltd. | 2.74 |
| Sanwa Bank, Ltd. | 2.67 |
| Sumitomo Bank, Ltd. | 2.66 |
| Bank of Tokyo, Ltd. | 2.64 |
| Mitsui Bank, Ltd. | 2.63 |
| Mitsubishi Trust & Banking Corp. | 2.44 |
| Sumitomo Trust & Banking Co., Ltd. | 2.39 |
| Mitsui Trust & Banking Co., Ltd. | 1.75 |
| Norinchukin Bank | 0.57 |

Source: American Banker

Maruyu savings accounts - Tax-exempt small savers accounts (maruyu) played an import role in helping Japan to rebuild after World War II. By the 1980s, however, the saving promotion had come under criticism from abroad. Washington urged Tokyo to cut incentives to save as part of a policy of macroeconomic coordination aimed at curing the huge bilateral current account imbalance. Tokyo complied April 1, 1988, sharply curtailing who was eligible to open a maruyu account and imposing a flat tax on all interest income.

In advance of the change savers immediately moved approximately Y3 trillion ($21.4 billion) out of the previously tax-exempt instruments in both February and March. For February 1988 commercial banks reported a Y2.5 trillion ($17.9 billion) jump in time deposits bearing market-determined interest rates while overall time deposits (the majority of which are maruyu accounts) grew just Y800 billion ($5.7 billion), indicating that savers kept funds in banks but moved them into different instruments. Banks reported a net decline of around 2 percent in time deposits for March and April, increasing concerns in boardrooms.

The Postal Savings system, administered by the Ministry of Posts and Telecommunications, reported net declines in deposits for both February (Y1 trillion or $7.1 billion) and March (Y900 billion or $6.4 billion). Postal officials counted on a new "national bond fixed-amount savings" account that is a combination of long-term government bonds and time deposits to boost deposits.

On the other side of the coin, trust banks, life insurance companies and securities firms attracted new customers thanks to the maruyu changes. Agents reported that monthly purchases of single premium endowment insurance, which pays about 9 percent a year, have doubled since February and show no sign of slowing. Seven trust banks recorded growth of five-year loan trusts, which pay about 4 percent annually, at 10 times the previous year's level. Approximately Y420 billion ($3 billion) flowed into this type of instrument in April, exceeding all expectations. Finally, securities firms reported an April increase of Y1.7 trillion ($12.1 billion) in investment trusts, marking the fourth consecutive monthly rise. Most of the April activity took place in stock trusts, with Y1.7 trillion ($12.1 billion) in new accounts opened and Y878.7 billion ($6.3 billion) redeemed. Bond trusts rose a net Y351 billion ($2.5 billion), the first net gain in three months.

One year after the maruyu reforms, the trends are clear. Overall bank time deposits continue to move up thanks to growth of large-lot time deposits and money market certificates, both of which pay a market-determined return. The share of these two instruments as a percentage of total deposits has risen from 33 percent in January 1988 to just under 50 percent in May 1989. The growth of total deposits in the Postal Savings system barely paused in May and April 1988 and fears that the rate of growth would suffer have proven unfounded. Insurance companies, trust bankers and stock brokers also report firm growth of their alternative investment vehicles. Japanese savers are clearly diversifying and rationally seeking higher returns for their funds. It does not appear, however, that curtailing the maruyu system has curbed Japan's thrift.

Interest rate deregulation - The increasing use of free-market mechanisms is a key element in Tokyo's financial liberalization plan. Open markets generate pressures for change as well as create opportunities for foreign

competitors. MOF has worked steadily to dismantle the vast structure of regulated interest rates that greatly influences saving, borrowing and investment behavior. Institutional markets, such as the overnight call market, the bond repurchase market and other interbank markets, were the first to be freed beginning in the late 1970s. Deregulation of interest rates, the key to revolutionizing the entire retail financial market, was the next phase, and it affected both deposits and corporate loans.

• Deposits - Beginning with instruments such as large certificates of deposits, MOF allowed banks and other institutions to add large-lot time deposits and money market certificates to the family of instruments with open-market interest rates. MOF's procedure was conservative, allowing only large corporate investors to enjoy the benefits and risks first, then gradually bringing the new instruments within the reach of ordinary households. For example, certificates of deposit had a minimum denomination of Y100 million ($714,000) when first introduced, but now they can be in Y50 million ($357,000) units. Minimum denominations for large-lot time deposits fell from Y1 billion ($7.1 million) in 1985 to Y30 million ($214,000) in 1988. For small savers the minimum size of a money market certificate declined to Y10 million ($71,400) from an original Y50 million ($357,000). Before proceeding further with its plan to deregulate all interest rates paid on deposits, MOF encountered a major roadblock: MPT's Postal Savings system.

With more than Y30 trillion ($214.3 billion) in deposits and 23,000 outlets, the Postal Savings system is a formidable competitor. Moreover, the system offers a savings option that commercial banks cannot. Teigaku deposits yield a preferential rate of return with only minimal restrictions on withdrawal privileges and a maximum denomination of Y5 million ($35,700). MPT was unwilling to give up this advantage, while commercial banks insisted that any interest deregulation plan for savings must include reform of the postal system and teigaku deposits.

After months of talks, MOF and MPT achieved a compromise. As of June 5, commercial banks were allowed to offer money market certificates with a minimum denomination of just Y3 million ($21,400) and maturities of six months or one year. Maturities of three months, two and three years will be added in October. These Super MMCs should help commercial banks retain depositors lured away by equities, mutual funds and other instruments that earn higher returns. The Postal Savings system also began to offer the new MMC and a modified teigaku instrument (a fixed-term, high-interest deposit). With a Y7 million ($50,000) upper limit, the new teigaku will bear an interest rate between 3 percent and 80 percent of the rate paid on three-year MMCs. The rate on six-month Super MMCs is pegged at 1.25 percentage points below the CD rate, while that for one-year Super MMCs is set 0.75 percentage point lower. Interest rates will be adjusted monthly based on the average CD rate for the previous month. Compared with the 0.26 percent per annum return on regular bank savings accounts, the 1.68 percent that post office savings accounts earn and the 3.4 percent to 3.6 percent return on time deposit accounts, MMCs will offer a return of 3.75 percent to 4.5 percent. It is not surprising that an estimated Y427 billion ($3.1 billion) worth of Super MMCs and Y208 billion ($1.5 billion) worth of Post MMCs were sold on the first day.

Bankers already are adjusting activities to meet the added strain of offering market interest rates to more depositors. Major commercial banks are

raising more of their funds from sources with freely determined interest rates so they can better match assets and liabilities under fluctuating interest rate conditions. Industry watchers expect banks to raise all their funds from free market sources within two years. Japanese banks previously raised money from sources with interest rates set by MOF or the Bank of Japan.

MOF has announced plans to continue cutting the minimum size of MMCs, beginning with a cut to Y1 million ($7,143) on April 1, 1990 and perhaps reaching as little as Y100,000 ($714) within a few years. Beginning this October MOF will give banks the green light to offer a hybrid instrument. Customers with ordinary deposit accounts can link them with a MMC and then borrow against the combination. This is somewhat similar to overdraft protection on checking accounts in the United States. Postal savings offices will offer their version of this new hybrid starting in April 1990.

• Corporate loans - Mitsubishi Bank, Ltd. took a revolutionary step this year by unpegging its short-term prime commercial loan rate from the Bank of Japan's discount rate. On January 23 Mitsubishi Bank raised its prime rate to 4.25 percent from 3.75 percent, subject to negotiation with its borrowers. The higher rate of interest should increase Mitsubishi Bank's profits, helping to boost its equity to meet the BIS requirements.

Commercial borrowers responded negatively to the rate hike for two reasons: they feel it is excessive, and it is unclear how Mitsubishi Bank set the rate. The current prime rate is 0.875 percentage point above BOJ's discount rate. Mitsubishi carefully avoided mentioning any rate-setting formula in its announcement, generating uncertainty among corporate clients. Japan's fourth-ranked bank previously had floated the idea of setting its prime rate 1 point above a four-instrument average (involving certificates of deposit, large-lot time deposits, discount bills and call money), but it withdrew the proposal under customer criticism. Other banks have followed Mitsubishi's lead to the chagrin of their customers. Mitsubishi's move will boost corporate interest in alternative financing, such as commercial paper or equity.

Securities -- A Rising Star

Japanese equity markets have been stellar performers since the October 1987 global stock market crash. The Tokyo market was the first to erase the October 1987 decline and has gone on to set new records with amazing frequency. Fears that the market was overvalued and headed for a major correction so far have proven to be overblown. With the current economic expansion nearing its third anniversary, the bulls are looking stronger than ever. With so much money flowing, it is not surprising that foreign financial institutions' interest in Japan's equity markets remains strong despite disappointing initial attempts to gain a foothold.

• TSE membership for foreign firms - After two waves of liberalization, foreign companies have 22 of 114 seats on the Tokyo Stock Exchange. The TSE board has decided that there is room for still more new members, foreign and domestic, and is examining which firms are both interested and qualified to join. While American firms benefited the most from previous membership drives, British and domestic firms are expected to gain more seats the next time around. The TSE hopes to have the groundwork laid by the summer of 1990.

FY 1988 was not the best of years for the TSE's foreign members. Only 8 of the 22 managed to break even or make money. This was, however, an improvement over the previous year when only five avoided recording red ink. The experience has led some to pull back or redirect their marketing efforts toward traditional areas of strength. Others, including Salomon Brothers (Asia) Ltd., Morgan Stanley Group Inc. and Goldman Sachs International Corp., have managed to build up a sufficient client base to generate enough trading volume to survive (commissions are fixed in Japan; in the United States variable rates are the rule, making volume not quite so critical). Most firms showing losses, however, profess a willingness to persist. Tokyo's market is now so large and active that a presence is almost mandatory for global competitors.

• Insider trading - Beginning in mid-1987 a series of scandals involving questionable stock transactions focused Japanese attention on the structure of domestic financial institutions and trading practices. In one case several Japanese banks and brokers avoided losses by acting on inside information that Tateho Chemical Industries Co., Ltd. was on the verge of bankruptcy because of huge losses from unauthorized trading in the yen bond futures market. In another, Recruit Cosmos Co., Ltd. privately placed its stock with 76 investors, including top political leaders' aides, who then made large profits when the company went public. Although the transactions occurred in 1984 and 1986, details of both only became public in mid-1988, igniting a major political scandal. In a third case, the price of Sankyo Seiki Manufacturing Co., Ltd. shares rose dramatically immediately before its July 29, 1988 announcement of a tie-up with Nippon Steel Corp. The less-than-severe penalties imposed on a handful of company officials raised eyebrows.

Although tougher Ministry of Finance securities rules approved by the Diet in May 1988 were to have gone into effect April 1, 1989, the rash of cases prompted MOF to implement parts of the legislation sooner. The ministry received stronger surveillance powers effective August 23 (Article 154 of the Securities and Exchange Law) and put in place more explicit rules governing insider trading (Articles 188 and 189) October 1. Lastly, the criminal provisions relating to insider trading were implemented April 1, 1989.

After consultations with brokers, MOF issued guidelines for the pricing of new stock issues and for private placement of shares. The effect of the rules is to prevent unrealistic prices for new issues, dampen efforts by traders to manipulate the price of new issues, and prevent heavy discounting of share prices for private placements. MOF also has set strict rules on the release of information that may affect share prices. Firms must provide any "nonpublic" information simultaneously to stock market officials and to at least one major media organization and then wait 12 hours before trading their own stock based on that information. Any trading before the 12 hours elapse constitutes insider trading.

The Japan Securities Dealers Association also took steps to restore confidence in the over-the-counter market, which was damaged by the Recruit Cosmos scandal. The JSDA board extended to three years a one-year ban on transfers of a stock between the time it is registered and it is listed. Registration procedures were strengthened, and the reporting of all transactions of unlisted stocks is now required. The Tokyo Stock Exchange and other bourses also are taking steps to prevent their employees from engaging in insider transactions.

The biggest changes, however, occurred within securities companies. Nomura Securities Co., Ltd. announced July 1, 1988 that it was separating its corporate finance and trading departments -- building a "Chinese Wall" to prevent inside information from passing between the two. All major brokers and many large corporations followed Nomura's example by physically separating the two staffs and establishing rules preventing financial communications between them.

The maintenance of Chinese Walls is standard practice in American and European financial institutions, where conflict of interest rules are much clearer. The step is unprecedented for Japan, where the concentration of economic and financial power has reached levels that would be considered unacceptable in the West. It has been an unspoken rule in Japan that the brokerage house that wins the right to underwrite a new corporate stock issue will do everything possible to inflate the price of that issue to make it successful. With Chinese Walls in place, however, this becomes more difficult. Foreign competitors in particular have complained that the existing unified structure gives Japanese firms an unfair advantage and actually promotes insider trading.

Many observers are pessimistic about the effectiveness of the new rules. First, the investigation and the enforcement arms of MOF, JSDA and the stock exchanges are small in comparison to the volume of trading. While the U.S. Securities and Exchange Commission has over 800 investigators with strong investigative powers, MOF's securities bureau has less than 200 and generally relies on cooperation with private firms. The volume on the Tokyo floor can exceed 1 billion shares a day, while the TSE's surveillance staff numbers just 31. JSDA is even shorter-handed; six persons monitor the entire Japanese over-the-counter market. Both the rules and mild penalties (a maximum fine of Y500,000 ($3,571) and six months in jail) are coming under increasing fire. MOF counters that the rules are meant to be preventive, rather than punitive. Give the system a chance before passing judgment, the ministry urges. But some analysts argue that even a thoroughly safeguarded system will not eliminate the problem, which will require a more fundamental shift to address the root cause. The highly concentrated nature of Japanese industry and finance puts too much power in too few hands, making abuse endemic, they say. Their advice: A complete restructuring of the industry may be the only solution.

- NTT shares - Seven foreign securities firms won the right to join the underwriting syndicate for the third issue of government-held shares of Nippon Telegraph and Telephone Corp. Although foreigners are not allowed to own NTT stock, foreign brokers placed over 87,000 shares of the 1987 offering in the secondary market, with seven accounting for 10,000 shares each. Five American subsidiaries -- Merrill Lynch Japan Co., Salomon Brothers, Goldman Sachs, Morgan Stanley International Ltd. and First Boston Securities Ltd. -- and two British brokers -- Kleinwort Benson & Co. and S.G. Warburg & Co. -- joined 26 Japanese firms as primary underwriters.

MOF and the Ministry of Posts and Telecommunications (which nominally owns the government's shares of NTT) now are negotiating on whether to allow foreigners to buy NTT shares in this year's auction, tentatively planned for October. In view of the 50 percent fall in the price of NTT shares since 1987, MOF favors foreign buyer participation to stimulate the market price (MOF is counting on the sale to bring in at least Y1.3 trillion ($9.3 billion) to help with its budget planning). MPT justifies its no-foreign owner policy on national security grounds. MOF counters, however, by pointing out that foreigners

can buy stock in both American Telephone and Telegraph Co. and British Telecom Plc as long as they remain minority shareholders. If Japan does not allow some foreign ownership of the "privatized" NTT, it could become a point of friction with trading partners.

Banker's acceptance market - As part of the 1984 yen-dollar accord between Washington and Tokyo, the Ministry of Finance created a domestic market for yen-denominated banker's acceptance bills. The purpose of the market was twofold: to facilitate imports by converting shippers' receivables into cash more quickly and to promote the use of the yen in international trade. The instrument, introduced in June 1985, initially was a success, with the volume of BAs quickly reaching Y58.7 billion ($419.3 million). Since then, however, the market has shriveled to the point where most analysts predict it will disappear in the near future. The outstanding BA market balance at the end of this June was just Y700 million ($5 million).

Paradoxically, the success of Tokyo's financial liberalization program is bringing the demise of the BA market. Rather than sell their trade bills to banks at a discount, exporters and importers now can borrow directly from banks at the prime rate, which is less costly than the trade bill discount.

Commercial paper market - In contrast to the BA experience, Japan's experiment with a commercial paper market is roaring ahead. Since the November 1987 inauguration of the market, the number of participants that can issue commercial paper, which is a promise to pay based solely on the company's good name, has grown from an initial 178 to over 200. The outstanding balance of the CP market topped Y11 trillion ($78.6 billion) at the end of this July, a gain of Y930 billion ($6.6 billion) for that month alone.

Japanese corporations have grown more sophisticated in the use of the CP market. At first the major participants were mainly large Japanese trading companies that issued CP for trade finance and investment purposes (another reason why the BA market has faded). Today, however, a wide range of corporations use the CP market not only for fund-raising but for financial speculation as well. For example, many corporate money managers recently have taken advantage of a gap between the cost of borrowing funds on the CP market (under 5.5 percent) and the interest earned on large-lot time deposits paid by banks (5.6 percent) by issuing CP and then depositing the funds in a large time deposit account.

MOF is considering further improvements to the market, including allowing maturities of less than one year, reducing the minimum issue amount to Y10 million ($71,400) from Y100 million ($714,000), eliminating the need for a company to be rated each time it wants to issue CP and allowing CP futures to be traded. MOF also probably will drop the 0.1 percent stamp tax now imposed on every CP transaction. The Japanese CP market is likely to grow as domestic companies become more familiar with it and Japanese subsidiaries of foreign firms become eligible to enter the market.

Offshore Banking - The Finance Ministry dropped several controls April 1 on the flow of funds between domestic accounts and the two-year-old offshore market, the Tokyo International Banking Facility. From now on, foreign investment funds held in domestic bank accounts worth up to 10 percent of the previous month's offshore account balance can be moved to offshore accounts each month. Accounts of less than Y1 billion ($7.1 million) can shift the entire

sum between onshore and offshore accounts each month. All controls on the outflow of offshore funds have been dropped. The changes more than double the amount of funds that can be moved monthly in and out of offshore accounts. Outstanding deposits in the Tokyo IBF totaled over Y414 billion ($3 billion) at the end of 1988 (see JEI Report No. 14A, April 7, 1989).

Euroyen market - European money markets have earned a just reputation for being the most open and free in the world. As such, they have been both a valuable training ground for Japanese financial institutions and an increasingly important source of funds and profits for Japanese corporations.

The Euroyen bond market now accounts for about 10 percent of the total Eurobond market, just ahead of the Deutsch Mark-denominated bond market but well behind the Eurodollar bond market's 55 percent share. Not surprisingly Japanese firms are very active in all Euromarkets. In the Euromarket for dollar-denominated warrant bonds, Japanese firms floated 175 issues worth $20.1 billion in 1987 and 196 issues worth $26.7 billion in 1988. The pace for the first half of this year is even more torrid, reaching 122 flotations worth $39.5 billion, according to a major Japanese broker. As for Euroyen bonds, another trader estimates that just over Y1.9 trillion ($13.6 billion) worth were floated in 1988. In both markets Japanese brokers have taken over completely as lead managers. Japanese issuers accounted for more than half of all Euroyen issues and at least one-third of all Eurodollar issues; they feel that the Big Four Japanese securities houses will be in a better position to handle the surge of trading that will occur in Japan when the warrants are exercised. Foreign firms, however, have found a profitable niche as comanagers. In fact, American and European firms have generated greater bond volume than the Japanese companies by focusing on comanagement.

Even Japanese banks are trying their hand at underwriting Eurobonds. European subsidiaries of the Industrial Bank of Japan, the Long-term Credit Bank of Japan, Ltd., Mitsubishi Bank and the Bank of Tokyo, Ltd. all rank within the top 30 Eurobond managers. Japanese banks are handicapped, however, by an informal Finance Ministry guidance that ensures that a Japanese bank will always have a subordinate status to a Japanese securities firm when they both participate in a Eurobond issue.

Domestic bond market - The once-slumbering domestic bond market, insulated from foreign financial forces, has a new day ahead. Gone are the rules and requirements that made corporate bonds an unattractive option compared with bank loans. The orderly government bond market now incorporates an open auction system not previously used for flotations. These vast changes stem primarily from an expansion of the national debt (currently over 40 percent of gross national product) and liberalization of bond rules and regulations.

- Private bonds - In a continuing effort to make Japanese markets competitive with those overseas, MOF eased regulations governing the domestic market for bonds tied to stock-purchase rights. Hoping to bring some of the Euromarket business back home, MOF decided April 1, 1989 to allow domestic underwriters to separate the warrant (the right to purchase new stock at a set price within a fixed period) from its underlying bond, a practice allowed in Europe and the United States. Brokers now can meet the varied needs of different clients by offering the warrant, which attracts small investors interested in the stock market, separately from the bond, which large institutional investors consider advantageous to hold.

Daiei Inc., a major supermarket chain, was the first to take advantage of the changes. Response to its June 29 issue of Y40 billion ($285.7 million) worth of warrant bonds was greater than expected but not overwhelming. The Big Four securities firms are expected to dominate any domestic business that does develop, although many Japanese brokers have diverted manpower to this area. Foreign firms expect to make small gains from this field; four U.S. firms participated in the Daiei offering to the tune of just 0.65 percent.

The infant bond repurchase market, which opened in April, is having teething troubles. In this market an institutional bond owner loans bonds to another financial institution in exchange for a fee with the understanding that the bonds will be returned by a specific date. Pension, trust and insurance firms can generate immediate income from their bond portfolios, while bond dealers have greater flexibility to play the market short or cover their positions. Unlike the existing gensaki bond repurchase market, the borrower can specify exactly what bonds he wants to borrow. Just as important, the new bond repurchase instrument is not subject to a transaction tax as gensaki deals are. The new market has not fulfilled expectations, dealers say, because of several rules that favor the bond lender.

• Government bonds - Washington's interest in ensuring equivalent access for U.S. firms to Japan's primary government bond market has grown along with the increasingly key role of Japanese investors in the initial market for U.S. government securities. The Treasury Department's May 1988 quarterly offering revealed the strong financial links that have sprung up between the two countries and explains why some in the United States are concerned that control of monetary policy is becoming unduly influenced by foreign considerations.

At least partly in response to reports that Japanese fund managers were unenthusiastic about the bond sale's prospects, Treasury postponed the $26 billion quarterly auction to avoid a three-day Japanese holiday at the start of May. In addition, reports of unexpectedly strong U.S. economic activity had raised fears of an overheating economy and higher interest rates. Managers were worried that the yield on 30-year bonds would jump as high as 9.25 percent compared with the coupon value of 8.875 percent. Worries over the yen-dollar exchange rate also plagued Japanese managers. Underlying the Americans' immediate concern was a fear that this situation could create a vicious cycle since less Japanese investment in U.S. bonds would reduce demand for dollars, pushing the dollar's exchange rate down and making dollar-denominated instruments even less attractive.

In the end, however, there was no visible reduction in Japan's participation. Japanese bidders won an estimated 20 percent of the $8.75 billion worth of three-year treasury notes, carrying an average yield of 8.23 percent. Treasury officials reported that the bid-to-cover ratio (the value of bids made divided by the amount accepted) was 2.95 which compared favorably with the last auction's 2.43 ratio. As for the $8.75 billion worth of 10-year notes auctioned the next day, Japanese investors bid successfully for 35-40 percent. The average yield on the notes was 9.06 percent, a slim margin given the 9 percent coupon. In this case the bid-to-cover ratio was also higher than before, coming in at 2.61 versus 2.04. About half of the final day's auction of $8.5 billion worth of 30-year bonds went to Japanese bidders, who pushed up the bid-to-cover ratio to 2.55, well above the previous 1.98 mark. Yields ranged from 9.16 to 9.18 percent, with the average 9.17 percent level the highest average yield since early 1986.

On the one hand, Washington was happy with the results since it helped stabilize interest and exchange rates and kept the U.S. economy growing. On the other hand, Japanese purchases of at least 34.8 percent and at most 36.5 percent of the May auction drew inevitable comparisons with foreign access to Japan's primary government bond market. Under the postwar system, the terms of each Japanese bond issue are negotiated between the government and the executive committee of an 815-member syndicate, with each member receiving a fixed share. In the past the 34 foreign securities brokers and 30 foreign banks in the syndicate were allocated just 2.5 percent of each issue. This disequilibrium gave rise to a provision in the Omnibus Trade and Competitiveness Act of 1988 that would bar foreign companies from the U.S. primary market unless American firms have access to "the same competitive opportunities in the underwriting and distribution of government debt instruments issued by that country as it accords to domestic companies."

The primary dealers provision contained in the 1988 trade law claims that "in contrast to the barriers faced by U.S. firms in Japan, Japanese firms generally have enjoyed access to U.S. financial markets on the same terms as American companies." The statute lists the following "barriers" for foreign firms in Japan: limitation on membership on the Tokyo Stock Exchange; high fixed commission rates (up to 80 percent), which must be paid by nonmembers of the TSE to members for executing trades; unequal opportunities to act as lead manager for, or even participate in, equity and bond underwritings; restrictions on access to automated teller machines; arbitrarily applied employment requirements for opening branch offices; long delays in processing applications for operating licenses; and restrictions on foreign-owned institutions' participation in Ministry of Finance policy advisory councils. The law specified that if these conditions were to continue after August 23, 1989, "neither the Board of Governors of the Federal Reserve System nor the Federal Reserve Bank of New York may designate, or permit the continuation of any prior designation of, any person of a foreign country as a primary dealer in government debt instruments."

A team of Fed officials visited Tokyo January 24-31 to meet with representatives of the Finance Ministry, the Bank of Japan and major commercial banks and brokerages. The American team reportedly focused keenly on at least one aspect of the Japanese system. Japan Bond Trading Co., Ltd., which serves as a clearinghouse for trading between bond brokers, has been accused in the past of favoring domestic dealers by selectively leaking information. Foreign dealers in Japan and some Japanese institutions have voiced unofficial complaints about the practice. A spokesman for Japan Bond Trading denied that any leaks occurred and pointed out that new computer software and ethics codes have been instituted to make leaks more difficult.

In October 1988, well under the one-year deadline imposed by the trade act, MOF raised the bond syndicate allocation for foreigners to 8 percent from 2.5 percent. Four foreign firms also were invited to join six Japanese companies on the syndicate's executive committee to negotiate directly with MOF on future offerings. Salomon Brothers Asia became a permanent executive committee member, with the three remaining posts being filled the first year by Goldman Sachs, Shearson Lehman Hutton Inc., and Kleinwort Benson. The second year appointees are Merrill Lynch, Morgan Stanley and Jardine Fleming Securities Ltd., and in the third year Citicorp Scrimgeour Vickers International Ltd., First Boston and S.G. Warburg will have seats. Most important, MOF increased April 1, 1989 the portion of each auctioned offering of 10-year notes from 20

percent to 40 percent. The terms of the remaining 60 percent of the issue are set at the average of the competitive bids. Finance allows firms with an allocation of less than 0.3 percent to participate in a noncompetitive bidding system to ensure that these companies also gain a larger share.

The first flotation held under the new system surpassed MOF expectations. The April 5, 1989 auction of Y400 billion ($2.9 billion) worth of 10-year bonds, 40 percent of April's total issue, brought an average price on the 4.8 percent coupon issue of Y99.91 per Y100 of face value, a surprising Y1.2 above the price of the March issue. MOF reported that it had received bids worth Y2.9 trillion ($14.9 billion) and accepted Y389.9 billion ($2.8 billion).

Strong competition from foreign bidders, according to market analysts, drove the price well above the expected Y99.5 level. There were four American brokerages among the successful bidders: Salomon Brothers won Y20 billion ($142.9 million), First Boston received Y15 billion ($107.1 million), and both Goldman Sachs and Shearson Lehman Hutton bought Y2.4 billion ($17.1 million). The American share of the auctioned bonds alone thus reached about 10 percent.

The new system apparently placated the Federal Reserve, at least for the moment. The Fed governors August 21 approved a staff report by a vote of 5 to 1 that found no "discrimination against U.S. firms in the laws and formal regulations applicable to the government debt market." While praising Tokyo for the changes, the report also listed several concerns that still exist, including greater market efficiency, improvement and control of information flows, and continued sensitivity to foreign concerns in the liberalization process. Several Fed governors who voted in favor of the report expressed the hope that Tokyo would continue to improve foreign access to its government bond market. If not, they warned, this decision could be revisited as early as next August.

The Fed's positive but wary attitude did little to calm mixed American feelings about the decision. Some feel that Tokyo gave up little to gain completely open access to the U.S. bond market. Others feel that the decision removes pressure from Tokyo to continue liberalizing its market. Tokyo has not yet responded to the Fed decision but remains aware of being watched closely.

Financial futures and options - Although commodities futures have a long history in Japan, financial futures are a recent innovation. Trading in government bond futures started in 1985 to facilitate Tokyo's debt rollover operations. In June 1987 the Osaka Stock Exchange introduced a quasi-stock futures instrument, the Osaka 50, which has proved moderately successful. Two true stock futures began trading September 3, 1988. One, based on the Tokyo Stock Price Index (Topix) of 1,117 first-section issues, is traded on the Tokyo Stock Exchange; the other follows the 225-stock Nikkei Average and is traded on the Osaka floor. The two contracts allow investors the full range of futures activities: hedging, arbitrage between futures and spot prices, and arbitrage between the two futures themselves. Learning from the U.S. "Black Monday" experience of October 1987, the new markets have a 3 percent daily limit on movement up or down. The contracts can be settled in cash only (no delivery of stock), a rejection of a reform proposed for the U.S. market.

Trading of stock futures outperformed all expectations as the volume of futures trading quickly matched the underlying real market. It is clear that the market is still immature, however. Japanese investors are experimenting

timidly with the new instrument, concentrating on futures with the shortest terms and changing positions often. Securities firms have done the bulk of trading, mostly on arbitrage activities. Even here, however, the approach is rather basic, focusing on the spread between the real and the futures market. Trading based on differences between the two futures indices (the Topix and the Nikkei 225) or between domestic and overseas indices (particularly the Nikkei Index traded on the Singapore International Monetary Exchange) is miniscule. Given its sound start, however, refinement and sophistication will surely come.

Banks began trading government bond futures June 5 for their clients. Previously banks were allowed to trade only for their own accounts, while their clients had to engage a securities broker to take advantage of this instrument. A total of 82 banks, including four foreign ones, initially qualified to begin operations.

In November 1988 the Finance Ministry allowed domestic firms to trade for their own accounts in foreign financial futures offered on the Chicago Board of Trade, the Chicago Mercantile Exchange, the London International Financial Futures Market and the Singapore International Monetary Exchange. The foreign experience was a prelude to the June 30 opening of the Tokyo International Financial Futures Exchange, which offers Euroyen interest rate futures, Eurodollar interest rate futures and yen/dollar exchange rate futures.

After an initial flurry of congratulatory opening day trading, TIFFE volume plunged and became focused on Euroyen trading (see Table 2). Traders explain that they prefer the Singapore exchange for Eurodollar futures because of its ties with the Chicago Mercantile Exchange. The tie-up not only expands the number of trading hours each day but offers greater liquidity and depth. As for yen/dollar futures, dealers say that TIFFE is superfluous. The existing Tokyo interbank foreign exchange market can accommodate huge transactions (lessening the need to hedge with futures) and does not impose a 9 percent margin deposit as TIFFE does. TIFFE's manual trading system also draws traders' complaints for being too slow, especially when a delay of only a few minutes in confirming a transaction can mean the difference between profit and loss.

Table 2: Weekly Volume of the Tokyo International Financial Futures Exchange

(number of lots)

| Week Ending | Euroyen Interest Rate | Eurodollar Interest Rate | Yen/Dollar Exchange Rate |
|---|---|---|---|
| June 30, 1989* | 141,625 | 29,413 | 4,125 |
| July 7 | 93,219 | 8,849 | 1,052 |
| July 14 | 73,728 | 7,835 | 256 |
| July 21 | 73,269 | 3,788 | 240 |
| July 28 | 118,544 | 6,755 | 503 |
| August 4 | 82,856 | 3,189 | 470 |
| August 11 | 88,760 | 2,996 | 528 |
| August 18 | 92,102 | 2,981 | 497 |

*First day of trading only

Source: Nihon Keizai Shimbun

TIFFE officials nonetheless are pleased with the results so far, saying that the current average daily volume of just over 40,000 lots surpasses the 30,000-lot expectation. TIFFE is examining whether to install a computerized trading system to meet speed and volume demands. Officials also have widened the bidding range on yen/dollar futures from 7 points to 15 points to encourage more participation as well as take into account more volatile spot exchange rates (one point is $0.000001). Most observers predict that only the Euroyen instrument will prove viable, since it is unique to the exchange.

Japan's first true stock index option was made available to institutional investors June 12, 1989. As it did with stock futures, the Osaka Stock Exchange gained the jump on its Tokyo rival by offering a true index option based on the Nikkei 225 index. TSE hopes to offer a competing product based on the broader Topix index this fall. The third-ranked Nagoya Stock Exchange will offer a third option contract, based on a 25-stock index of its own creation. While index options are used widely in the United States as a way for large investors to hedge their bets in the underlying cash market, it is not clear if the instrument will be as popular in Japan. Investors must deposit Y20 million ($142,900) with a broker before being allowed to dabble, and brokers are complaining that the commissions have been set too low to really interest them. In addition, the options are traded manually rather than by computer, severely restricting trading activity. Ministry of Finance efforts to actively involve foreign firms in the new market also have not lived up to expectations. Of the 90 clearing members on the new exchange, only four are based overseas. Until foreign brokers develop a domestic client base, observers feel that non-Japanese participation in the options market will be limited.

Japan's commodity futures markets are the next target of Tokyo's liberalization efforts. Under current rules Japan's commodity markets are unattractive compared with foreign counterparts. Trading in metals futures, for example, is restricted to gold, silver or platinum. In addition, foreign firms have been barred from being full members of commodity exchanges. As a first step toward liberalized markets, 24 foreign firms were invited March 10, 1989 to join the Tokyo Commodity Exchange for Industry as associate members; full membership almost surely will follow when regulations permit. To alleviate problems associated with the actual delivery of metals (Japanese firms have complained of losses from price fluctuations while the goods were in transit), the top-ranked London Metal Exchange plans to open metals warehouses in Tokyo, Osaka and Nagoya. TCEI will link its trading operations with its U.S. and European counterparts in September 1990 and hopes to offer precious metals options in 1991.

Unlike most of the other financial liberalization, which falls in MOF's domain, commodity markets come under the primary control of the Ministry of International Trade and Industry, which plans changes to the existing Commodity Exchange Act that would allow foreign firms to become full members of any exchange and the introduction of trading in commodities options and futures. MITI also is considering introducing trade in crude oil futures within five years and opening a nonferrous metals exchange. The Ministry of Agriculture, Forestry and Fisheries also has a role in commodity market liberalization: preparing for trading in agricultural futures. Liberalizing commodity markets is likely to take some time since a variety of ministries must rewrite a vast number of laws and regulations.

Japan as King of the Hill

Japan and the United States are highly status conscious societies. The rapid growth of Japan's financial might has upset international rankings of financial institutions long dominated by American firms. But beyond their public relations or ego value, what are the practical implications of this rank reordering?

Japanese banks now dominate the international rankings according to the traditional measures of deposits and assets (see Table 3). Aided by the sharp appreciation of the yen against most major currencies but particularly the dollar, Japanese banks are now head-and-shoulders above the competition by these often-used measures. By two other measures, however, the Japanese banks seem less formidable. As mentioned earlier, Japanese banks fair poorly when judged by their equity-to-asset ratios. Profit rankings, too, make Japanese banks seem less imposing.

Table 3: Deposits, Assets and Profits of Selected Japanese and American Banks

(in millions of dollars)

| Company | Deposits | Assets | Profits |
|---|---|---|---|
| Dai-Ichi Kangyo Bank, Ltd. | $312,465.8 (1) | $386,937.3 (1) | $1,061 |
| Sumitomo Bank, Ltd. | 296,000.8 (2) | 376,087.8 (2) | 992 |
| Fuji Bank, Ltd. | 283,585.4 (3) | 364,043.9 (3) | 873 |
| Mitsubishi Bank, Ltd. | 269,427.0 (4) | 343,593.5 (5) | 845 |
| Sanwa Bank, Ltd. | 269,032.3 (5) | 348,358.0 (4) | 866 |
| Industrial Bank of Japan, Ltd. | 215,397.6 (6) | 257,577.9 (6) | 456 |
| Norinchukin Bank | 210,759.5 (7) | 241,947.3 (7) | n.a. |
| Mitsubishi Trust & Banking Corp. | 185,955.5 (8) | 210,456.8 (10) | 542 |
| Sumitomo Trust & Banking Co., Ltd. | 177,932.2 (9) | 196,588.7 (12) | 514 |
| Tokai Bank, Ltd. | 175,600.9 (10) | 225,121.1 (8) | 464 |
| Citibank NA | 104,996.0 (27) | 146,177.0 (24) | 1,698.0 |
| Bank of America NT&SA | 69,640.0 (44) | 81,651.0 (48) | 547.0 |
| Chase Manhattan Bank NA | 58,241.3 (55) | 74,990.9 (53) | 1,058.9 |
| Morgan Guaranty Trust Co. | 45,471.7 (70) | 70,064.8 (59) | 1,001.8 |
| Manufacturers Hanover Trust Co. | 42,876.0 (75) | 52,849.0 (78) | 752.0 |
| Security Pacific National Bank | 36,095.3 (84) | 48,358.1 (82) | 638.9 |
| Wells Fargo Bank NA | 35,109.1 (88) | 43,487.1 (89) | 512.5 |
| Chemical Bank | 33,298.0 (95) | 50,233.0 (81) | 753.6 |
| Bankers Trust Co. | 33,261.4 (96) | 52,340.0 (79) | 647.7 |

Notes: Number in parentheses is rank among the top 500 banks worldwide, according to the American Banker. Figures list deposits and assets as of December 31, 1988. Profit figures are for latest fiscal year available.

Sources: For deposits and assets, American Banker. For profits, Business Week and Fortune.

Interestingly, the Japanese and Americans switch positions when leading securities brokers are compared (see Table 4). The American companies look strong in terms of revenues and assets, but the Japanese firms earn substantially higher profits, which translate into greater cash reserves. The opposite fortunes of the Tokyo and the New York stock exchanges since October 1987 may account for much of the disparity in profit levels. While the TSE has enjoyed a steady boom, the NYSE has struggled upward until its recent surge. The cause of Nomura's stunning profit performance is unclear, but the figures are consistent with a surge that began in 1987.

Table 4: Revenues, Assets and Profits of Selected Japanese and American Financial Service Companies

(in millions of dollars)

| Company | Revenue | Assets | Profits |
|---|---|---|---|
| Nomura Securities Co., Ltd. | $6,677.1 | $29,368.0 | $1,494 |
| Daiwa Securities Co., Ltd. | 4,155.5 | 32,936.0 | 831 |
| Nikko Securities Co., Ltd. | 3,588.6 | 23,189.0 | 552 |
| Yamaichi Securities Co., Ltd. | 3,401.7 | 23,042.0 | 552 |
| Salomon Brothers Inc. | 6,146.0 | 85,256.0 | 280 |
| Merrill Lynch & Co. | 10,547.2 | 64,402.7 | 463 |
| Morgan Stanley Group Inc. | 4,108.8 | 40,050.8 | 395 |
| Shearson Lehman Hutton Inc. | 10,529.0 | 84,800.0 | 97 |

Notes: Figures for revenue and assets as of December 31, 1988. Profit figures are for the latest fiscal year available.

Source: Morgan Stanley Capital International

For various reasons, a growing faction in the international financial community believes bigger is not necessarily best. Because deregulation of capital markets has integrated national financial markets to an unprecedented extent and off-budget accounting has become prevalent, an institution's operations and its profitability are no longer reflected adequately by total deposits and assets. While deep pockets often are necessary to finance today's global transactions and can help attract top talent, they do not necessarily guarantee sophistication and experience. Japanese banks are probably the clearest example. There is no doubt that they have the funds to become major players in the U.S. merger and acquisition market, but their lack of expertise is equally evident. The same can be said for Japanese brokers on Wall Street. Despite a lot of money to deal, they have little experience working the market.

The Japanese understand their weaknesses and are striving to use their current assets to the best advantage. By bankrolling foreign firms with desirable expertise the Japanese are beginning the long learning process that will make them stronger competitors.

## The European Challenge

While Japanese financial firms have built a strong presence in Europe, the Euromarket is scheduled to undergo a revolution in a few years. The 13-nation European Community is rapidly moving toward becoming a more complete

economic union beginning in 1992. For the continent's financial markets, however, the impact of the 1992 integration will come sooner. Each community member has agreed to eliminate its residual controls on intra-EC capital flows, eliminate regulatory barriers to cross-border financial service transactions and fully support the European Monetary System by July 1, 1990.

The proposed 1990 changes have added even greater urgency to the Japanese rush to prepare for Europe 1992. Just as Japanese manufacturers are setting up production facilities within the EC, Japanese financial firms are cementing their European ties to avoid being shut out by proposed financial reciprocity rules. Although stressing that a pending directive for banking and other financial services will not be protectionist, EC officials have made it quite clear that they intend to use access to a unified community as a tool to lever equal access abroad for European firms. Concern about the final directive in Tokyo is proportional to reports that the EC has compiled a long list of complaints against Japan and other countries. Both at the government and the private level, therefore, European-based Japanese firms are trying to present their case as convincingly as possible.

While most major Japanese financial companies have established offices in many EC countries, second-tier and smaller Japanese firms only now are seriously exploring opening European operations. One approach receiving greater consideration by both manufacturing and financial companies is the purchase of an existing European company. American brokers already are involved deeply in M&A activities in Europe. Accordingly, the EC Commission has announced that it wants to centralize approval authority for foreign acquisitions within the EC bureaucracy. While the EC claims this will facilitate foreign investment by providing "one-stop shopping," others see a more sinister intent. Whether member governments will be willing to give up this authority is a very open question.

The EC's planned 1992 integration presents a whole range of new challenges to Japanese financial institutions, not the least of which will be tougher competition from European firms strengthened by cross-border mergers. After some initial panic Japanese firms are settling down to adapt themselves to the changing business environment.

What's On Washington's Mind

It should be clear that in the financial area Tokyo has moved, if grudgingly at times, in directions urged by Washington. If one reviews the provisions of the 1984 yen-dollar accord, Japan has achieved almost all of its stated goals. Nevertheless, many Americans and Japanese agree that Japan's financial markets could benefit from further reform and liberalization. This does not mean that Japan's financial markets must evolve into carbon copies of U.S. markets. Herein lies the potential for continued financial frictions. Tokyo and Washington are scheduled to launch talks on structural impediments to trade in early September. Among other things the Bush administration wants to address two financial issues with Japan.

- Japanese patterns of saving and investment - The United States remains convinced that Japan saves too much and consumes too little. This savings-consumption imbalance contributes to the country's strong export performance and is therefore fair game for discussion. Since Tokyo already has effectively eliminated the tax-exempt small savings account system, it is not clear what Washington wants. The Japanese consumer finance industry has grown

by leaps and bounds over the past few years. Credit cards, charge cards, debit cards and prepaid cards all are accepted by Japanese consumers as necessities of life. Japanese banks now are putting greater emphasis on consumer loans because of their higher profitability. Unless Washington expects Tokyo to implement penalties for thrifty behavior, Tokyo can do little more to directly influence the behavior of Japanese savers.

• Stock cross-holding by Japanese companies - The practice where business partners hold a small stake in each other's company as a sign of sincerity has become deeply rooted in Japan. Families of companies in which a substantial portion of each member's shares is held by the rest of the group are highly visible features on the Japanese economic landscape. Some of these keiretsu or industrial groups are descendants of pre-war conglomerates (zaibatsu), such as Mitsubishi Corp., Mitsui & Co., Ltd. and Sumitomo Corp. These conglomerates were dismantled during the U.S. occupation of Japan but managed to reassemble themselves to some degree after the occupation ended. Other groups, such as the Fuyo, Dai-Ichi Kangyo Bank and Sanwa groups, formed after the war by clustering around a single bank in response to the extreme shortage of capital. Still others formed around a major manufacturer and usually consist of all the subcontractors that supply the central firm; the Matasushita Electric Industrial Co., Ltd. and Toyota Motor Corp. families of companies are good examples of this last type of keiretsu.

One side effect of this type of organization is that a significant portion of a company's stock is often held by companies that have no interest in selling or trading the shares. Combined with institutional investors that take a long-term view toward buying and holding stocks, as much as 70 percent to 80 percent of a company's shares may be withheld from the market. For any investor wishing to accumulate a sizable stake in a Japanese firm, these stock holding practices can become an impenetrable barrier. This situation is in total contrast to the U.S. equity market where small and large investors freely trade stocks and it is relatively easy to build a controlling stake in a firm.

This difference in market behavior combined with the massive upsurge in Japanese direct investment in the United States has led to charges against Japan of unfairness and closed markets. In a recent well publicized case, T. Boone Pickens, a U.S. corporate raider, bid for a voice in the management of a Japanese automotive lighting manufacturer but was rebuffed by that firm despite his status as the largest stockholder. Immediately following this development, a Japanese corporate raider ran into similar resistance from two Japanese supermarket chains -- again despite his significant stake in each firm.

The issue of stock cross-holding in Japan thus is linked tightly to several others, including an aversion to hostile mergers and acquisitions and the traditionally low regard by management for shareholder's concerns. By opening the pandora's box of stock cross-holding, the United States may become enmeshed in Japan's basic social and cultural mores. Nevertheless, these recent developments have sparked a debate in Japan over these precise issues, perhaps opening the way for gradual change.

For further information, contact Jon Choy

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.